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No. 71-799

In the Supreme Court of the United States

OCTOBER TERM, 1971

UNIVERSITY HILL FOUNDATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A 548-578) is reported at 51 T.C. 548. The opinion of the court of appeals (Pet. App. B 1-17) is reported at 446 F. 2d 701.

JURISDICTION

The judgment of the court of appeals was entered on May 17, 1971. A petition for rehearing, with a suggestion for hearing *en banc*, was denied on September 20, 1971 (Pet. App. D). The petition for a writ of certiorari was filed on December 17, 1971.

QUESTION PRESENTED

Petitioner, a corporation organized to raise funds for a university, acquired 24 going businesses which it leased to others for rent consisting of 80 percent of the profits. The question presented is whether petitioner is exempt from income taxation under Section 101(6) of the Internal Revenue Code of 1939 and Section 501(c)(3) of the 1954 Code. Resolution of that issue turns on whether petitioner's business operations constituted nothing more than "rental by an organization of its real property (including personal property leased with the real property)" within the meaning of Section 101 of the 1939 Code and Section 502 of the 1954 Code.

STATUTES INVOLVED

The pertinent statutes, Sections 501(c)(3) and 502 of the Internal Revenue Code of 1954, are set forth in Appendix C to the petition.[1]

STATEMENT

Petitioner was organized for the purpose of raising funds for Loyola University of Los Angeles.[2] It acquired a number of businesses pursuant to a plan or formula under which petitioner purchased the assets or the stock ownership of going businesses, and leased the assets back to the former operators, or others, without any disrupting change in the conduct of the busi-

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[1] Identical provisions contained in Section 101 of the 1939 Code (as amended by Sec. 301(b) and (c)(1), Revenue Act of 1950, c. 994, 64 Stat. 906) are also involved. References to the controlling statutory provisions hereinafter will be to the 1954 Code.

[2] Loyola University is an educational institution exempt from federal income tax under Section 501(c)(3) of the 1954 Code (Pet. App. A 549-550).

ness. The lessees usually agreed to pay petitioner "rentals" of 80 percent of the net profits of the business, sometimes reduced to 60 percent after total payments had reached a specified amount. Petitioner agreed to pay to the former owners as the purchase price a percentage of the rentals received from the lessee, usually 90 percent, plus the proceeds from the sale of any capital assets. Generally, petitioner was required to make purchase-money payments only out of the rentals received, with the shares acquired by petitioner and/or the underlying assets being pledged as security for payment. Under this plan, it was contemplated that petitioner, as a tax-exempt organization, would incur no tax liability on the receipt of the rental payments, that the operating group, to which the businesses were leased, would be able to deduct the rent as a business expense, and that the profit on the sale of the stock or assets of the going businesses by the original owners would be taxed at capital gain rates. (Pet. App. A 549, 551, 553-554, 555.)

From November 11, 1945 to October 31, 1954, petitioner acquired 24 going businesses, including a hotel, factories, a printing plant, sand, gravel and concrete companies, port facilities, a scrap collection company, recording laboratories, a foundry, and dairy companies. The assets acquired included land, buildings, machinery and equipment, current assets, trade names, goodwill, *etc.*, comprising generally all of the assets used in the going businesses. Most of the businesses were operating profitably at the time of acquisition and continued to be profitable thereafter. (Pet. App. A 552.)

Petitioner at all times has maintained that it is

exempt from income taxation under Section 501(c)(3) of the 1954 Code as a corporation organized and operated exclusively for charitable purposes. Section 502 provides that so-called "feeder" organizations—those operated primarily for the purpose of carrying on a trade or business for profit, but which distribute all of their profits to an exempt organization—shall not be exempt under Section 501 merely because all of their profits are payable to an exempt organization. However, petitioner has relied on the Section 502 proviso that a trade or business does not include "rental by an organization of its real property (including personal property leased with the real property)."

The Tax Court, five judges dissenting, held (Pet. App. A 574) that petitioner "was exempt from tax by virtue of Sections 501(c)(3) and 502." A divided court of appeals reversed, holding that petitioner was not exempt from tax under Section 501(c)(3) (Pet. App. B 2), and that the transactions undertaken (Pet. App. B 12) "do not fall within the proviso of the feeder organization amendment, now Section 502 of the 1954 Code."

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review. Moreover, the issue presented has been rendered moot for the future by amendments to the Code enacted by the Tax Reform Act of 1969.

1. Petitioner primarily contends (Pet. 3) that the court of appeals interpreted one statutory provision—Section 501(c)(3)—which did not require interpreta-

tion and "ignored the narrow question of statutory interpretation presented by the parties * * *"—the real property leasing proviso of Section 502. On both counts, petitioner is in error.

If petitioner is exempt from income taxation, it must qualify under Section 501(c)(3). Section 502 provides a general rule denying the benefits of Section 501 to "feeder" organizations, but contains a proviso with respect to the leasing of real property nullifying the general rule of Section 502 and reinstating qualification under Section 501. Under these circumstances, as a preliminary to interpretation of the proviso, it was both appropriate and necessary for the court of appeals to begin its analysis with the terms of Section 501(c)(3) and the pre-1951 judicial interpretation of that provision. In view of the fact that Congress changed the law with respect to "feeder" organization exemptions for years after 1950, it obviously was relevant to focus upon the law being changed. In construing statutory provisions "there is need to keep in view the background of their history. There is need to keep in view also the structure of the statute, and the relation, physical and logical, between its several parts." *Duparquet Co.* v. *Evans*, 297 U.S. 216, 218.

As for petitioner's claim (Pet. 16-20) that the court of appeals failed to interpret the Section 502 proviso, it is enough to point out that the Ninth Circuit devoted a major section of its opinion to precisely this issue (Pet. App. B 8-13). Finding that both parties' arguments with respect to the plain meaning of the proviso were inconclusive, the court stated (Pet. App. B-9) that "the application of the proviso to the case before us

cannot be properly determined without an inquiry into the legislative history of the feeder organization amendment."

From a detailed examination of that legislative history, clearly reflected in its opinion, the court of appeals concluded (Pet. App. B 12) that the transactions undertaken by petitioner "do not fall within the proviso of the feeder organization amendment * * * *." Rather, the court found that the general rule of Section 502 was aimed at denying exemption to organizations such as petitioner, and that (Pet. App. B 11) the proviso was "intended only to protect feeder organizations whose income derives from real-estate investments of the 'passive' nature traditional among exempt institutions."

Petitioner thus is not helped by what it describes (Pet. 17) as the court of appeals' "admission" that the literal terms of the proviso did not preclude exemption. For the court determined also that the literal terms of the proviso did not extend exemption to petitioner. In order to qualify therefor, it was incumbent upon petitioner to identify itself as one of the types of organizations Congress intended to favor. *Universal Oil Products Co.* v. *Campbell*, 181 F. 2d 451, 457 (C.A. 7), certiorari denied, 340 U.S. 850. This it failed to do.

2. Petitioner's assertion (Pet. 9) that the decision below conflicts with *Commissioner* v. *Brown*, 380 U.S. 563, ignores both the difference in the issues presented and the statutes involved. *Brown* involved transactions similar to those here. But it did not involve the issue of exemption from tax of the alleged charitable organization, but only the question whether the payments re-

ceived by the seller of the business would qualify for capital gains treatment. In *Brown*, this Court decided that the word "sale" as it appears in the general definition of long-term capital gain in Section 1222(3) of the 1954 Code should be given its ordinary meaning in the context of a "bootstrap" sale of stock to an exempt organization. The Court declined to read into the word "sale"—which appears some 635 times in Subtitle A alone—a requirement that the risk of the business shift from the seller as a condition of long-term capital gain treatment. Moreover, the legislative history cited to the Court was barren of any specific reference to the precise issue involved. Here, in contrast, the question of interpretation involves a word combination which appears nowhere else in the Internal Revenue Code, and the legislative history of the 1950 amendments discusses both the type of activity which Congress intended to tax and that which it intended to exempt.

3. Petitioner strains to show (Pet. 20-23) that the instant case remains administratively important despite the amendments to Sections 502 and 512 effected by the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, Sec. 121(b)(2). But the critical fact remains—and petitioner nowhere denies it—that petitioner would not be exempt under the statutes as amended (set out at Pet. 21-22), which have prospective effect only. This fact alone is sufficient to divest this case of any current administrative importance.[3]

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[3] Sections 502 and 512, as amended, provide, in their combined operation, for the denial of exemption if real and personal property are leased together, and the amount of rent attributable to personal property exceeds 50 percent of the total rent, or if the rent is com-

4. Similarly lacking in merit is petitioner's contention (Pet. 18-20) that the court of appeals, in characterizing petitioner as a "used-business dealer," disregarded a finding of fact made by the Tax Court and a stipulation of the parties. The Tax Court did not specifically find as a fact the kind of business in which petitioner was engaged, or even whether it was engaged in any business at all—these are questions of law determinable upon the basis of the undisputed basic findings. With respect to the stipulation of capital loss treatment for certain assets sold, it should be observed that there is no rule of law prescribing ordinary income or loss treatment for every asset that a dealer sells. But whether petitioner was a "used-business dealer" or not, it is apparent that petitioner was not engaged in the passive type of investment activity traditional among exempt institutions. No more was necessary to dispose of this case, given the court of appeals' conclusion that only the latter activity is exempt under the proviso to Section 502.

5. There is no basis for petitioner's claim (Pet. 11) that the decision below "reintroduces chaos" that existed prior to the enactment of the Revenue Act of 1950. As elaborated fully by the court below (Pet. App. B 3-5), a conflict of decisions had developed prior to the enactment of the Revenue Act of 1950. Some courts

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puted in terms of a percentage of income or profits derived by any person from the leased property. Section 512(b)(3)(B). Moreover, even if those tests are satisfied, exemption is denied where the amount of rent attributable to the personal property is more than incidental in relation to the total rents under the lease. Section 512(b)(3)(A). Petitioner would be disqualified from exemption under each of these three tests.

of appeals had held that so-called "feeder" organizations were exempt from federal income tax under the exemption provision predecessor of Section 501(c)(3) of the 1954 Code, even though they engaged in purely commercial activities with no exempt purpose other than that their profits were distributed to exempt owners. Other courts of appeals had held that such "feeder" organizations were not exempt from tax.

In 1950, Congress enacted the Revenue Act of 1950, c. 994, 64 Stat. 906. Section 301(b) of the Act amended Section 101 of the 1939 Code by adding at the end thereof a paragraph, which has been continued, substantially unchanged, as Section 502 of the 1954 Code. This legislation was designed to supersede earlier judicial decisions which granted exemption by applying the "destination of income test." H. Rep. No. 2319, 81st Cong., 2d Sess., p. 124; S. Rep. No. 2375, 81st Cong., 2d Sess., p. 116.

As the Ninth Circuit explained (Pet. App. B 7-8), every court of appeals that has considered the 1950 amendment has concluded that Congress specifically intended to reject the rule affording exemption based solely on "destination of income." There is simply no authority for petitioner's statement (Pet. 13) that in enacting the "feeder" organization provision of the Revenue Act of 1950 "Congress codified *neither* conflicting line of authority but rather rejected *both*." The pre-1951 conflict eliminated by Congress did not involve distinctions between those organizations primarily engaged in business and those not engaged in business at all, and to represent, as petitioner evidently does, that the destination of income test was preserved in Section

502 to cover more than the passive rental activity traditionally engaged in by exempt organizations (Pet. 15) is merely to reiterate its argument that the court of appeals wrongly interpreted the Section 502 proviso.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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